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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals (R. 14) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41) is reported in 105 F. (2d) 740.

Jurisdiction.

The judgment of the Court below was entered August 8, 1939 (R. 45). A petition for rehearing was denied below

September 15, 1939 (R. 46). The petition for the writ of certiorari was filed December 12, 1939 and granted March 25, 1940. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

The adjusted net income of the petitioner for the calendar year 1936 was $12,032.72. As of January 1, 1936 the petitioner had a capital deficit of at least $21,251.40. No dividend was declared during the year and no dividend could be declared because a North Dakota Statute (Appendix, p. 49) prohibited the corporation paying dividends except from surplus profits arising from the corporation's business and there was no surplus but a deficit.

The questions presented are:

1. Whether, for the purpose of the relief granted in the determination of the surtax on undistributed profits under the Revenue Act of 1936, the taxpayer's charter constitutes "a written contract executed by the corporation," part of the provisions of which consists of the general corporation law of North Dakota? If not, whether the taxpayer's stock certificate constitutes a written contract executed by the corporation part of the provisions of which is the general corporation law of North Dakota?

2. Is the law, as construed by the Court below, of such doubtful constitutionality as to warrant the Court in construing it so as to avoid the doubt?

3. Did the Court below fail to apply established rules for the construction of taxing Statutes and reach its decision by the application of contrary rules?

Statutes and Regulations Involved.

Pertinent statutes and regulations are set forth in the appendix, *infra*, p. 49.

STATEMENT.

In the case at bar certiorari was granted because of direct conflict with *Northwest Steel Rolling Mills, Inc.* v. *Commissioner*, 110 F. (2d) 286 (C. C. A. 9). The amount of tax involved is $1,707.36.

The facts in this case were stipulated (R. 12) and the Board found the facts as stipulated (R. 14). It was stipulated that petitioner was incorporated under the statutes of North Dakota, April 29, 1903. That as of January 1, 1936, petitioner had a deficit of at least $21,251.40. There was a surplus in March, 1930 (R. 12)[1] so this deficit was incurred after that date.

Petitioner's net income for the taxable year 1936 was $13,450.76 (R. 12-13). Its adjusted net income was $12,-032.72 (R. 13, 14). The statute of North Dakota expressly forbade its directors to declare any dividend in 1936 because its capital was impaired and none was declared. As stated by the Court below the State Supreme Court has construed this statute to forbid dividends (R. 42).

[1] In his brief in opposition to the petition for certiorari on page 14 thereof, respondent stresses a statement in the stipulation that the records prior to 1929 are not susceptible of analysis to show how the deficit occurred. But the stipulation also shows that there was a surplus in March, 1930 (R. 12, Par. 4). In view of this the stipulated deficit did not occur prior to January, 1929 but subsequent to March, 1930. Hence it is of no consequence that the records prior to 1929 are not susceptible of analysis and there is nothing to this argument of respondent. Since under the North Dakota statute a dividend cannot be declared except from surplus and since a deficit is the converse of a surplus and the existence of a deficit was stipulated, it is clear that no dividend could be declared and both Tribunals below decided the case on this basis.

In its return for 1936, petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,771.36 on undistributed profits, and asserted a deficiency in that amount (R. 12, 13). The Board of Tax Appeals approved the action of the Commissioner relying wholly on legislative history (R. 14-22) and this action was affirmed by the Circuit Court of Appeals (R. 41) but on entirely different grounds.

In addition to the other income taxes (a normal tax of from 8 to 15 per cent and an excess profits tax from 6 to 12 per cent) Congress by the Revenue Act of 1936 imposed a special undistributed profits surtax of from 7 to 27 per cent on the portion of earnings which corporations did not distribute as dividends to their stockholders. The law was designed to permit corporations to avoid this special tax by distributing their earnings. Its purpose was to prevent rich men avoiding the high personal surtax by accumulating money in corporations they controlled, the corporate rate being lower than the high individual surtax.

It was recognized by Congress that in certain cases corporations could not distribute dividends, albeit they might desire to do so, and in such cases to prevent discrimination in favor of corporations able to pay dividends a credit was allowed. The provision allowing credit in such case and which the petitioner claims is applicable in this case is the provision of 26 (c) (1) of the Revenue Act of 1936 in the following language:

> "An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

In the case at bar petitioner's adjusted net income for 1936 was $12,032.17 and since its capital impairment was at the beginning of the year, $21,271.41, there was no excess of adjusted net income which could be distributed as dividends without violating the provision of its written charter contract and its stock certificate, which contained the state law expressly dealing with the payment of dividends, and hence we contend its case falls literally within the above quoted statute and that accordingly it is entitled to the credit thereby allowed.

It was conceded below and must be conceded here that if petitioner's charter constitutes a written contract executed by petitioner which contract contains a provision which expressly deals with the payment of dividends, then petitioner's case falls literally within the statute and the decision of the Court below was wrong and petitioner is entitled to the credit. The same is true if its stock certificate constituted such a contract. The Court below ignored this last point about the stock certificate, although petitioner urged it in brief and oral argument.

Since petitioner's charter was executed prior to May 1, 1936 and in April, 1903, the statutory requirement of execution prior to May 1, 1936 is met and the first question in this case is whether the charter is "a written contract executed by the corporation" and if so whether this contract contains the State Corporation Law which law concededly contains a provision which "expressly deals with the payment of dividends." If not then is the stock certificate such a contract?

Petitioner claims that its charter is a written contract between its stockholders, itself and the State, that the Court below correctly said this charter consists among

other things of the express provisions of the State Corporation Law to the same extent as if it had been actually printed in the charter and that the provision of this State law, which the charter contract contains, "expressly deals with the payment of dividends." If this contract was "executed" by it petitioner is entitled to the credit allowed by the above provision of the Revenue Act and is literally within it. * * * Moreover, it is claimed to deny such credit in this case is to discriminate against the petitioner in favor of other taxpayers which are subject to other restrictive contracts and therefore similarly situated with respect to the payment of dividends, in violation of the Fifth Amendment. It is also to create indispensable discrimination by giving a rich corporation an option to avoid the tax and none to a poor corporation tottering on the verge of insolvency.

Petitioner further claims that the surtax on undistributed profits is framed upon the premise that the income to be taxed shall be distributable by the taxpayer corporation, and that it is a violation not only of the design of the taxing law but also of the Fifth Amendment to impose the surtax on its income which was not distributable. It claims the law did not intend to penalize failure to do an act the doing of which was illegal.

The Treasury regulation (Art. 26-2, Reg. 94) promulgated under the 1936 Revenue Act expressly declared that a charter would not be considered a written contract within the above-quoted provision of the law. It said nothing about a stock certificate. This regulation, however, has not been approved by the re-enactment of the statute because the short experience under the undistributed profits tax proved it a failure and it was not re-

enacted, the result it sought to accomplish being attainable in other ways.* Shortly after its promulgation the regulation was questioned by disinterested academic sources, XII Indiana Law Review 19, 28; 36 Columbia Law Rev. 1343, 85 U. of Penn. Law Review 89, and has been continually questioned since.

Basis of Board of Tax Appeals Decision.

The Board of Tax Appeals held in this case (see its Opinion, R. 14) that irrespective of whether the charter was a contract executed by petitioner expressly dealing with the payment of dividends the legislative history of the statutory provision involved showed Congress did not intend to embrace such contract within this provision of the law solely because the Revenue Act of 1936, as it passed the House, contained a provision giving relief to ALL deficit corporations including those not forbidden to declare dividends and this provision was omitted in the Senate bill and by the conference draft (differing radically from both House and Senate bills) that became law. Concededly there is nothing in the legislative history showing why it was omitted. Petitioner argued in the Circuit Court of Appeals that this reasoning of the Board was palpably erroneous for the reason that, if legislative history could be considered, the provision contained in the House bill granted relief to all deficit corporations, including those existing in states where they might legally declare dividends and the Senate considered this too broad and therefore struck it out, evidently considering that corporations restricted by contract from declaring dividends, alone should have relief, and that those free to distribute dividends were not entitled to relief. (See R. pp. 26, 27.) The Board also stressed that the Senate changed the definition of a dividend to afford relief to deficit cor-

*The effect of this regulation is discussed at page 21.

porations which did distribute dividends. However, this change was necessary to afford relief to deficit corporations which did distribute dividends in the twelve states where they might lawfully do so, otherwise such corporations would not have been entitled to any credit for a dividend distribution because it would not be taxable to the stockholders. In changing this definition Congress did not have in mind corporations which could not distribute dividends. If it did it would be saying to them, "if you violate state law we will allow you a tax credit." Of course it had no intent so to do.

Basis of Opinion of Court Below.

The Circuit Court of Appeals considered the aforesaid objections to the Board's decision and affirmed but on an entirely different ground than that upon which the Board put its decision (R. 41). The ground of the decision of the Circuit Court of Appeals was, (1) "The corporation itself has made no written contract affecting its right to declare dividends," and (2) "If there is such a contract, it is not an express one, but is implied."

After considering this opinion of the Court below the Circuit Court of Appeals for the 9th Circuit in a later case rejected it as unsound, saying "it confuses the wording of the statute." 110 F. (2d) 286, 289.*

The Court below entirely ignored our contention that the stock certificate was a contract executed by the corporation and complied with the words of the Revenue Law allowing a credit.

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*It is respectfully submitted that the opinion confuses more than the wording of the statute. It confuses the distinction between an express and an implied contract. Section 5884 of the Civil Code of North Dakota defines an express contract as follows: "An express contract is one the terms of which are stated in words."

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In failing to hold that petitioner was prohibited from distributing any of its 1936 earnings as dividends because of a written contract executed by it prior to May 1, 1936, which contract contains a provision expressly dealing with the payment of dividends.

2. In affirming the order of the Board of Tax Appeals.

3. In failing to hold that the statute as construed by it was so arbitrary and unreasonable that it violated the Fifth Amendment.

Summary of Argument.

Petitioner's charter and stock certificates were issued in 1903 and if executed by petitioner they comply with the provision of the statute requiring execution prior to May 1, 1936.

The first point we make the Court below conceded. It is that the statute of North Dakota expressly prohibited a corporation without a surplus distributing any of its earnings in dividends and allowed dividends to be made only out of surplus and that it had been so construed by the North Dakota Supreme Court. The Court below correctly stated (R. 41, 42):

> "Sec. 4543 of the North Dakota Compiled Laws of 1913 provides that: 'The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, pay to the stockholders, or any of them, any part of the capital stock.''

Again the Court below correctly declared in its opinion (R. 42):

> "The Supreme Court of North Dakota has held that a dividend can not rightfully be declared by a corporation except out of the profits earned by it and that this principle is embodied in the North Dakota statutes above referred to. *Ulness* v. *Dunnell* (N. D.) 237 N. W. 208. Similar statutory provisions were in existence when petitioner was incorporated."

The construction of this state statute by the North Dakota Supreme Court is of course binding on all the Federal Courts. *Erie R. Co.* v. *Tompkins,* 304 U. S. 64. Besides, the state statute is so clear as not to require construction.

The second point we make is that the words of the above quoted statute of North Dakota, which concededly expressly deal with the payment of dividends, are a part of petitioner's charter and the Court below also conceded this. The Court below correctly said petitioner's charter included "as it doubtless does, the North Dakota statutes" (R. 42). Again the Court below said:

> "The charter of a corporation organized under general law consists of its articles of incorporation and the laws applicable thereto." (R. 43).

The balance of the argument for petitioner may be summarized in the following five points, all of which are sustained by unanimous authority and none of which we submit can be denied: (1) A corporation stock certificate is in writing. (2) It is a contract. (3) If the word "executed" as used in the statute is held to mean "signed" then a stock certificate is signed by the corporation under its seal. (4) It contains the written provision of the State Corporation Law as fully as if that provision were recop-

ied verbatim therein; and (5) This provision of the State Corporation Law expressly deals with the payment of dividends and prohibits such payment.

If the above five points are true (and we submit they are) the petitioner is literally within the statute and is entitled to the credit.

The legislative history set forth at page 28 hereof shows Congress intended stock certificate contracts to be embraced within this statutory provision. The rulings of the Treasury Department cited on page 28 hereof show that if the provision of State law dealing with dividends had been recopied into the stock certificate the respondent would have conceded the credit, yet this State law is as fully and to the identical extent a part of the stock certificate as if it were recopied therein. Substance and not form is controlling in tax cases. To recopy it in the certificate would add nothing. To construe the law as granting the credit in one case and not in the other results in an absurdity and also renders the Statute unconstitutional. See *Miller* v. *Nut Margarine Co.*, 284 U. S. 498, 510.

The quotations on page 31 hereof from the impartial law reviews of our leading law schools (Harvard, Yale, Columbia, University of Pennsylvania) agree with petitioner that the stock certificate complies with the statute.

In addition to the foregoing we also submit that none of the following points can be denied: (1) The corporate charter is a contract. (2) It is in writing. (3) It includes the written provision of the State law which expressly deals with the payment of dividends and prohibits them. The Court below conceded this point but denied point (1).

We submit the only point that can be reasonably disputed is whether the charter is "executed" by the corporation. We submit when the corporation accepted it in 1903 and began to act under it, it thereby became a party thereto and executed the same. It has continued to operate under this charter for 37 years. "Charters of private corporations are regarded as executed contracts between the government and the corporators," *Pennsylvania College cases,* 13 Wall. 190, 212. The word "executed" is contained in a relief provision and the uniform rule for the construction of such a provision is that it is to be construed liberally. This must be coupled with the other rule that doubts in the construction of tax statutes must be resolved against the government and in favor of the taxpayer. Furthermore the legislative history shows Congress attached no hypertechnical meaning to the word "executed" and that the proponents of the legislation in the Conference Committee, which wrote the law before the Court, stated it granted relief to corporations forbidden by law to declare dividends. No provision of the law could do this except the one before the Court.

Also the spirit and purpose of the statute supports the construction for which petitioner contends. Its purpose was to force rich men accumulating money in corporations (for the purpose of taking advantage of lower corporate taxes and avoiding the higher individual surtaxes) to distribute the corporate earnings and pay taxes on such earnings. (See speech of Senator Black, 80 Cong. Rec., pp. 8813 and 8814). If a corporation without any surplus distributed a dividend out of its capital such dividend, being a return of capital, would not be taxable and if the capital was impaired the stockholder receiving the distribution would have a loss deductible from his other income and thus be able to reduce the taxes on his other

income. It was a penalty on the failure to declare dividends but surely Congress did not intend to penalize failure to do an act, which could not be done without violating state civil and criminal law and which, even if done, would not produce the result Congress enacted the law to bring about but an opposite result. A dividend by a deficit corporation would reduce the taxes payable by a rich stockholder.

It is not necessary for petitioner to convince the Court that the law as construed by the Court below is unconstitutional, but only to show that there is grave doubt about its constitutionality in order for this Court to construe it to avoid the doubt. Other Tribunals called upon to construe it have expressly stated that they were in doubt about its constitutionality if the construction contended for by respondent was the correct one. Thus the Circuit Court of Appeals for the Ninth Circuit stated in 110 F. (2d) at p. 290:

> "There seems to be grave doubts as to whether there is a reasonable basis for discrimination between a written contract actually 'signed' by a corporation prohibiting the payment of dividends, and the contract of the charter to which the corporation is as fully bound, likewise prohibiting the distribution of profits."

The Board of Tax Appeals stated in *Prudential Tobacco Co.*, 42 B. T. A. No. 80:

> "We are not entirely free from doubt upon the present question."

The law as construed by the Court below, puts a premium on the violation of the criminal and civil law of the several states; allows a rich and prosperous corporation an election to avoid the tax and none to the poor tottering corporation; by imposing burdens on the poor not imposed

on the rich it tends to destroy the poor corporation and leave its business to the rich one and thus creates monopoly which is against the statutory policy of the United States; it makes a baseless distinction between charter contracts and all other contracts and it does not operate with geographical uniformity within the United States because it gives deficit corporations incorporated under the laws of 12 states an election to avoid the tax and none to those incorporated under the laws of the other 36 states. Also it does not tax certain corporations situated the same as those it taxes.

ARGUMENT.

Point I.

The North Dakota Statute Expressly Prohibited Petitioner Declaring a Dividend.

Section 5884 of the Civil Code of North Dakota contains the standard definition of an express contract which is as follows:

> "An express contract is one the terms of which are stated in words."

The first point we make is that the express words of the North Dakota statute quoted on page 9 and in the Appendix at page 49 plainly and expressly prohibit a corporation without a surplus distributing a dividend. The Supreme Court of North Dakota has so construed this statute in *Ulness* v. *Dunnell*, 61 N. D. 95.

In that case the highest Court in North Dakota said at page 100:

> "It is a well settled principle that a dividend can not rightfully be declared by a corporation except out of profits earned by it. 6 Fletcher Cyc. pp. 6209 *et seq.*, *Fricke* v. *Angemeir*, 53 Ind. App. 140; 101 N. E. 321. In this state the principle is embodied in statute."*

As heretofore pointed out, in the quotations from the opinion of the Court below on page 10 of the Summary of Argument, the Court below conceded that the North Dakota statute had been construed by the State Supreme

*See the decision of this Court in **Mobile & O. R. Co. v. Tenn.**, 153 U. S. 486, 496. See also Vol. 11, Fletchers Cyc. of Corp., p. 838, Sec. 5335. Surplus is what remains after deducting all liabilities including the capital stock. **Helvering v. Canfield**, 291 U. S. 163, 166. **Willcuts v. Milton Dairy Co.**, 275 U. S. 215, 218; **Edwards v. Douglas**, 269 U. S. 204, 214.

Court to prohibit dividends and that petitioner's charter included "as it doubtless does the North Dakota Statutes." That the North Dakota Statute deals with the payment of dividends in express words and prohibits them being distributed except from surplus is beyond question. The stipulation shows no surplus, but expressly stipulates a deficit exists. Hence there was nothing from which petitioner could declare a dividend. In *Kinnear* v. *Commissioner,* 36 B. T. A. 153, the Board said at page 155:

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored. *Willcuts* v. *Milton Dairy Co.,* 275 U. S. 215; *Crystal Ice Co.,* 14 B. T. A. 682; *Arthur C. Stifel,* 29 B. T. A. 1145; *Louise Glassell Shorb,* 22 B. T. A. 644; *Loren D. Sale,* 35 B. T. A. 938. This rule is recognized by the Commissioner. G. C. M. 1552, C. B. VI-1, p. 10."

In *Foley Securities Co.* v. *Commissioner,* 106 F. (2d) 731, 732, 733, the Court quoted the above statement of the Board with approval and stated it was the uniform rule for income tax purposes.

Point II.

The Aforesaid State Statute Expressly Dealing With Dividends Is a Provision of Petitioner's Charter to the Same Extent As If It Were Recopied Therein.

That this statute is part of petitioner's charter can hardly be disputed and the Court below so held.

This Court and all others have repeatedly declared that the laws which exist at the time of the making of a contract become as much a part of it as if they were recopied therein. In the case of *Northwest Steel Rolling Mills* v. *Commissioner,* 110 F. (2d) 286 at p. 289, the Circuit Court

of Appeals for the 9th Circuit applied this principle to the same situation as the case at bar and quoted the unequivocal language of this Court as follows:

> "(4) It is settled law that: 'Laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as fully as if they had been expressly referred to or incorporated in its terms. *Farmers' Bank* v. *Federal Reserve Bank*, 262 U. S. 649, 660, 43 S. Ct. 651, 655, 67 L. Ed. 1157, 30 A. L. R. 635. See also *Von Hoffman* v. *Quincy*, 4 Wall 535, 550, 18 L. Ed. 403."

This principle has been stated many times in the hornbooks and in decided cases. *Northern P. R. Co.* v. *Wall*, 241 U. S. 87, 91. For its statement and application to corporate charters see Vol. 1, Fletchers Cyc. Corp., p. 440, Sec. 226. Also Vol. 2, Chap. 20, Sec. 765, p. 1736.

In *Ainsworth* v. *Southwestern Drug Co.*, 95 F. (2d) 172 (C. C. A. 5) the Court said at page 173:

> "Appellant argues that the charter and by laws of a corporation constitute a contract between a company and its stockholders into which the statutes of the State of its incorporation enter and are controlling. This may be conceded without discussion."

If the lawyer who incorporated petitioner had taken the trouble to recopy the state law into its Articles of Incorporation respondent would still not have conceded petitioner was entitled to the credit. This is because he claims the charter contract is not "executed" by the corporation.

Point III.

The Charter of Petitioner Corporation Is In Writing. It Is a Contract.

Among the multitude of authorities holding a corporate charter is a contract, see *Dartmouth College* v. *Woodward* (1819), 4 Wheaton 518 (17 U. S. 418) 628-683; *Home Building & Loan Assn.* v. *Blaisdell,* 290 U. S. 398, 429, 430; Corporations, 18 C. J. S., Sec. 71, p. 456; Corporations, 14 C. J., Sec. 162, p. 161; 7 Ruling Case Law, Sec. 71, p. 93; Cook on Corporations (8th Edition), Secs. 492-494; *Personal Industrial Bankers* v. *Citizens Budget Co.,* 80 F. (2d) 327, 328 (C. C. A. 6th) cer. den. 298 U. S. 674. The charter is a contract and it is in writing. Hence it is a "written contract."

Between the decision of this Court in the *Dartmouth College case* and its decision in the *Home Building & Loan Assn. case,* numerous decisions of this Court have repeated the doctrine that a corporate charter is a contract. In *Chenango Bridge Co.* v. *Binghampton Bridge Co.,* 70 U. S. 51, at p. 73, the Court said:

> "We have supposed, if anything was settled by an unbroken course of decisions in the federal and state courts, it was, that an Act of incorporation was a contract between the State and the stockholders. All courts at this day are estopped from questioning the doctrine. The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken.
>
> "A departure from it now would involve dangers to society that cannot be forseen, would shock the sense of justice of the country, unhinge its business interests, and weaken, if not destroy, that respect which has always been felt for the Judicial Department of the Government. An attempt even to reaffirm it, could only tend to lessen its force and obligation."

We do not multiply citations but all text books and innumerable decisions of lower Federal Courts and of all State Courts have uniformly repeated as elementary law the rule for which we contend. It is a fixed elementary legal principle which was well known to most members of the Congress. The Court will take judicial notice that most of them were lawyers and familiar with this elementary rule. As said in Corporations, 13 Am. Jurisprudence, Sec. 77, p. 220, of the *Dartmouth College case*:

> "This decision has received unanimous approval by the courts and has been followed and cited many times."

This elementary rule which the Court below ignored is thus stated in 14 C. J. 161, Sec. 162:

> "The charter of a corporation, whether it is created by a special act or formed under a general corporation law, is a contract between the corporation, or the corporators or members, and the state. It is a contract between the state and the corporation, between the corporation and the stockholders, and between the stockholders and the state."

In *Personal Industrial Bankers* v. *Citizens Budget Co.*, 80 F. (2d) 327 (C. C. A. 6), cer. den. 298 U. S. 674, the Court said at page 328:

> "We are here asked to construe a contract, for it is too elementary to require a citation and the parties agree that a corporation charter is a contract not only between the state and the corporation, but between the corporation and stockholders, and between the several classes of stockholders."

In the article on the Undistributed Profits Tax in XII Indiana Law Journal 19, at p. 28, apropos of the identical section of the income tax law involved here, it is said:

> "That the charter of a corporation is a contract was determined long ago in the famous *Dartmouth*

College case, and the charter in the case of the Indiana corporation contains provisions which 'expressly deal with the payment of dividends.' This would seem sufficient compliance with the requirements of Subsection 26 (c) (1) of the Act to entitle the corporation to credit when it is prevented from paying dividends by the terms of its charter."

In the article in 36 Columbia Law Review, p. 1343, it is said:

> "The Treasury has excluded corporate charters from the category of contracts thereby repudiating the traditional definition of a charter as a contract between the state and corporations."*

Every written contract is necessarily an express contract. North Dakota statute defines an express contract as one the terms of which are stated in words. In the case at bar the provision upon which we rely is in written words. If petitioner did not make the contract who did? Without at least two parties to it a contract cannot exist.

Every bank loaning money to a corporation with an impairment of capital stock does so in reliance on the corporation observing its contract with the State and not declaring dividends while this impairment exists. It would be superfluous for the bank to exact another contract to that effect.

Point IV.

The Charter Is a Contract "Executed" by the Corporation.

Petitioner was denied the credit in this case because Regulations 94, Article 26-2 promulgated under the Revenue Act of 1936, provided:

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*In fairness to the Treasury it is submitted the regulation was not intended to deny that a corporate charter was a written contract containing the State law but only to rule that it was not "executed" by the corporation and hence did not comply with the Revenue Act.

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of 26 (c) (2)."

We understand that it is not the intention of the Department by this Regulation to deny that the charter of a corporation is a written contract containing the law of the state expressly prohibiting the payment of dividends where a deficit existed (which it seems no one would deny in view of the foregoing authorities) but only to deny the credit because the Department takes the view that the charter contract is not "executed" by the corporation.

This regulation of the department has not been approved by the re-enactment of the statute and has very little effect because it has not been a long-continued regulation. *Iselin* v. *United States,* 270 U. S. 245, 250, 251; *Burnet* v. *Chicago Portrait Co.,* 285 U. S. 1, 16-21. Furthermore it is clearly an invalid regulation because it attempts to amend the law. *Manhattan General Equipment Co.* v. *Commissioner,* 297 U. S. 129, 134. Also while the Courts give great weight to administrative regulations the above regulation is not an administrative regulation but a regulation which seeks to interpret the law. As said in *United States* v. *American Trucking Assn.,* 310 U. S. ....., "the interpretation of the meaning of statutes as applied to justiciable controversies is exclusively a judicial function." The sharp distinction between the difference in weight given by the Courts to administrative regulations and interpretative regulations is pointed out in the excellent article in 52 Harvard Law Review 1163.* While it is the function of the executive department to administer the law it is the function of the Courts to interpret the law and this function

*In 40 Columbia Law Review 252 it is said the decision of this Court in the **Wilshire Oil Co. case** is "a striking example of the prevailing confusion." With regulations pouring out not only from all branches of the federal government but from forty-eight states it is imperative to clarify the rules as to their force and effect.

delegated to the Courts by the people in the constitution can not by the Courts be redelegated to the Executive Department. Nor can Congress confer it on the Executive Department. Furthermore the established rule in the interpretation of tax statutes is that all doubts must be resolved in the taxpayer's favor. The Treasury on the other hand is obliged when it drafts its regulations to apply the converse rule and resolve all doubts in the Government's favor because if it resolves the doubt in favor of the taxpayer the matter is at an end and the Courts will not be called upon to interpret the law. The Government is foreclosed. To permit a Treasury regulation made under the compulsion of resolving doubtful questions in the Government's favor to have much force is to substitute for the rule that all doubts and ambiguities must be resolved in favor of the taxpayer, the rule that doubts must be resolved in favor of a Treasury regulation, which as above pointed out must necessarily resolve doubts against taxpayers. It means nothing less than the abrogation of the time hoary rule and its replacement by the converse rule.

In 85 University of Pennsylvania Law Review at page 89, it is said with reference to the Section involved in this case:

> "Although these sections were made a part of the Act for the purpose of ameliorating possible hardship the Treasury Regulations bearing on the subject have practically destroyed all equity contained therein. * * * However, without entering into a technical discussion whether a charter of a corporation constitutes a contract in the orthodox sense, or constitutionally under the *Dartmouth College Case*, nevertheless it does appear that a corporate charter is within the spirit of the Section. It is probable that this regulation will not be upheld."

What then is the meaning of the word "executed" as used in the statute? Perhaps no word in legal phraseology has more varied meanings (Words & Phrases, Perm. Ed., Vol. 15, p. 555) which illustrates the legal axiom expressed

in the following classical language in *Towne* v. *Eisner*, 245 U. S. 418, at p. 425:

> "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."

The rule for the interpretation of this word is thus expressed in *Helvering* v. *New York Trust Co.*, 292 U. S. 455, 464. In interpreting the word this Court reiterated that it:

> "Will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute and the objects and policy of the law, as indicated by its various provisions, and give it such a construction as will carry into execution the will of the legislature."

It is submitted that the object and policy of the statute as well as its legislative history supports our contention that the word "executed" was used by Congress in the statute to mean "binding on." No reason can be suggested for Congress intending it to have any other meaning.

The legislative history of the Act conclusively shows that Congress attached no special importance to the word "executed." The Ways and Means Committee referred to a "written contract **in existence** prior to March 3, 1936." (See Ways and Means Committee Report 2475, 74th Cong. 2d Sess., p. 8). (Boldface ours.) The Senate Finance Committee referred to contracts "**entered into** prior to March 3, 1936." (Finance Committee Report No. 2156, 74th Congress, 2nd Sess. p. 12) (Boldface ours).

What reason would Congress have had in mind for requiring the corporation to sign the contract? If it had intended this it would have used the word "signed." Plainly what it was aiming at and its object and policy was to relieve the hardship which existed in cases where

a corporation was forbidden to distribute dividends, albeit it desired to do so. Witness the section relieving banks and insurance companies and the reason for it stated in Congress (see page 38 hereof). The word should be construed in the light of the situation Congress was trying to relieve. No reason supports its narrow construction. In *Fletcher* v. *Peck*, 6 Cranch 87, 137, it was held a grant was an executed contract. A charter is a grant of a franchise. Being a grant it is an executed contract. *Farrington* v. *Tennessee*, 95 U. S. 679, 683.

The word "executed" is often used to indicate completion of a legal document in such form that it becomes legally effective and binding. For example a will is not executed when the testator signs it but only when the requisite witnesses also sign. When one party has performed a contract it is said to be "executed." In the Law of Contracts an oral contract may be executed as well as a written one. Nor need the writing which executes a written contract be in the same paper as the terms of the contract itself, as a multitude of decisions applying the Statute of Frauds hold. Sometimes a signed check completes the execution of a written contract. After a corporation accepts and operates under its charter it signs and files the corporate reports required by the state law, which law is part of its charter contract, and it signs checks for franchise tax. Otherwise state law would forfeit its existence. If it amends its Articles of Incorporation it signs the amendment under its seal.*

When a corporation acts under a charter it executes the contract. *Cf. Pearsall v. Great Northern Ry. Co.*, 161

*An example of a "written contract" signed by one party only is an insurance policy. A deed is another. **Kittelson v. Collette**, 61 N. D. 768. In **Nat. Bank v. Moody**, 90 S. W. (2d) 279, 282, it is said a written telegram or other writing signed by one party constitutes a written contract if accepted by the other.

U. S. 646, 677. Thus it has been held a charter must be accepted by the corporation before it becomes binding on the state. *People* v. *Hoffman*, 116 Ill. at page 629. And a grant of a charter to a corporation which has neither officers or stockholders is not binding because there is no one competent to contract. *Aspen Co.* v. *Aspen*, 5 Colo. App. 17; 37 Pac. 730. In these two cases the contract was not executed by the corporations. But when a corporation accepts a charter it cannot surrender it without the consent of the other contracting party—the state. *Mechanics Bank* v. *Heard*, 37 Ga. 411. It is submitted the statement of the Court below that the corporation did not make the charter contract flies in the face of all authority. If there was a contract the corporation necessarily made it.

That Congress did not use the word "executed" to mean signed is evidenced by the fact that it could easily have said "signed" but did not do so. It should not be held to have meant what it did not say. For example if a bank accepted a written statement of the corporation that it would not pay dividends and made a loan in reliance thereon, this would be a contract executed by both parties, although the bank did not sign anything. Surely if Congress meant to say "signed" it would not have said "executed" instead. That it did not say "signed" shows it did not intend to exclude charter contracts.

The legislative history above set forth indicates that Congress used the word "executed" in the sense of a contract accepted by the corporation or binding on the corporation or a contract made by the corporation or to which the corporation was a party. Pertinent here are the rules for construction of the law quoted on page 41 hereof. The Court below took the view that the charter was not a contract "made" by the corporation. It did not discuss the meaning of the word "executed." On the other hand

the Circuit Court of Appeals for the Ninth Circuit gave careful consideration to the meaning of the word executed and discussed it at length and in 110 F. (2d) at the bottom of page 289 and the top of page 290, concluded that the charter was a contract executed by the corporation within the meaning of the law.* In *Pennsylvania College cases*, 13 Wall. 190, this Court at page 212 said a corporate charter was an executed contract.

The 1939 Cumulative Supplement to the Law of Federal Taxation, Paul & Mertens, contains an extended discussion of this subject in Section 32A.43, beginning at page 1455. The authors cite many authorities for the following statements at page 1458:

> "Are charters contracts 'executed by' the corporation? Congress seems to have given little special thought to its use of the word 'executed.' The Ways and Means Committee refers to a 'written' contract *in existence* prior to March 3, 1936 (this date being extended to May 1, 1936.' Later the Senate Finance Committee refers to contracts '*entered into* prior to March 3, 1936 (date extended as above stated.)' If the word 'executed' is to be given the meaning attributed to that word by previous decisions of the courts it should probably be held to require only such acts as are necessary to bind the corporation by the written contract in question. Precise formalities should be unimportant if there is a binding obligation. A broad meaning should be given to the word 'execute' which properly ignores technicalities."

By the theory of novation the corporation made the contract when it accepted the charter and operated and filed the reports required by law and paid franchise taxes under it. It then became bound by the provisions of the

*Supporting this view see also Montgomery Income Tax Procedure for 1937, pages 726, 727. See also C. C. H. 1936 Tax Service, paragraph 5279.

charter contract. Compare *Harrison* v. *Barker Annuity Fund*, 90 F. (2d) 286. The charter contract was then executed by it within the meaning of the statute. All doubts as to the meaning of "executed" are removed when the purpose and spirit of the law is considered.

But whatever attenuated technical arguments may be made by respondent that the charter itself is not a contract "executed" by the corporation it can not be denied that the stock certificate of every corporation is a contract executed by it under its seal.

Point V.

The Stock Certificate Is a Contract Executed by the Corporation. It Contains a Provision Expressly Dealing With the Payment of Dividends.

That the stock certificate of the petitioner corporation which is signed by it under its seal constitutes a written contract can hardly be disputed.

In re Culbertson's, 54 F. (2d) 753, 757 (C. C. A. 9); *Jones* v. *Mo. Edison Elec. Co.*, 144 Fed. 765, 770; *Continental Ins. Co.* v. *Minneapolis R. Co.*, 290 Fed. 87; *Yoakam* v. *Providence Biltmore Hotel Co.*, 34 F. (2d) 533, 541; 36 Columbia Law Review, p. 1343; *Geiger* v. *Seeding Machine Co.*, 124 Ohio State, 223 at page 237; *Dagg* v. *Hammons*, 34 Ariz. 445; *Clearwater* v. *Meredith*, 1 Wall 25, 40.

(*a*) The legislative history shows Congress intended a stock certificate to be embraced within the unqualified statutory term "written contract." (*b*) The treasury has consistently and correctly recognized in the rulings hereinafter cited that a stock certificate is a contract within the meaning of the clause of the statute involved in this case. (*c*) Also in the income tax case of *Helvering* v.

Salvage, 297 U. S. 106, 109, this Court recognized a provision in a stock certificate fixing the price at which a stockholder might sell to a corporation was a binding contract. In *Clearwater* v. *Meredith*, 1 Wall 25, this Court said: "When any person takes stock in a railroad corporation he has entered into a contract with the company." (*d*) Impartial academic commentators agree with unanimity that a corporate stock certificate satisfies the terms of the statute.

Subpoint A.

The Legislative History Shows Congress Intended Stock Certificates to Be Embraced Within the Words "Written Contract" as Used in the Statute.

The legislative history conclusively refutes the contention that Congress intended the phrase "written contract" to refer to only ordinary everyday contracts. The following colloquy took place between Mr. Vinson who was in charge of the bill and another member of Congress (80 Congressional Record, part 6, p. 6230):

> "Mr. Hollister: 'I am not discussing the debt situation. Let us assume this condition comes into effect with respect to a preferred stock issue * * *. Let us suppose in the preferred stock issue it is provided that in the event dividends are declared of more than a certain amount then certain voting rights will come into effect or certain things will have to happen. Has that been covered in any way?'
>
> Mr. Vinson of Kentucky: 'It seems to me that certainly comes under paragraph 14, the contract provision.'
>
> Mr. Hollister: 'That is not a contract.'
>
> Mr. Vinson: 'Certainly it is a contract.' "

By such representations those in charge of the bill procured its enactment. It is submitted Mr. Vinson, now Judge Vinson, was clearly right.

In construing the statute recourse may be had to the statement of the member in charge of the bill. *United States* v. *Great Northern Railway Co.*, 287 U. S. 144, 154, 155.

Subpoint B.

The Treasury Rulings Recognize That a Stock Certificate Is a Contract Within the Meaning of This Provision of the Statute.

The Treasury rulings have consistently recognized that a stock certificate is a contract within the meaning of the statute. Where provisions are set forth verbatim in the stock certificate restricting the payment of dividends it has held a contract within the provision of the law involved herein exists and the taxpayers are entitled to the credit. I. T. 3152, C. B. 1938-1, p. 155. This ruling cites other rulings such as I. T. 3139, C. B. 1937-2, p. 111.

So far as we can discover the argument has never been advanced to the Treasury Department that the provisions of the State law are incorporated in the stock certificate as fully as if they were actually copied therein under the rule stated by this Court in the quotation at page 17 hereof and it has never considered and rejected this argument. There is no Treasury ruling on the point.

There is no distinction between a case where these statutory provisions restricting dividends are printed in a stock certificate and where they are not printed therein. They are as completely and fully a part of it in one case as in the other. (See authorities quoted on page 17 hereof.) It would be a superfluous and meaningless act to print the provisions of a state law in a stock certificate. The lawyer would be extravagant who would have it done. The restriction in the State statute on the corporation's

right to declare dividends is exactly the same whether it is printed verbatim in the stock certificate or read into it by the rule of law stated in the quotation from this Court on page 14 hereof. "In the field of taxation administrators of the laws, and the courts, are concerned with substance and reality." Mr. Justice Black speaking for this Court in *Helvering* v. *Lazarus*, 308 U. S. 252, 255. No reason can be suggested why Congress could have intended any such meaningless distinction and one so devoid of reasonable basis as that which the respondent would have this Court make. There would be as much reason for granting relief in one case as in the other and no reason why it should be granted in one case and denied in the other can be suggested. The policy and spirit of the law with equal force dictates relief in both cases.

The phrase of the revenue law here involved only requires the provision of the contract to be one "which expressly deals with the payment of dividends." The law does not say that the provision expressly dealing with the payment of dividends must be expressly stated in the contract itself and certainly the above quoted phrase of the law cannot be made to say this without twisting its words and ignoring the rules for the construction of tax statutes long established and repeatedly reiterated by this Court, all other Courts and text-writers, and stated at page 42 hereof. As the Court of Appeals for the Ninth Circuit observed in refusing to follow the ruling of the Court below it "confuses the wording of the statute" on this question. See 110 F. (2d) at page 289.

AUTHORITIES IN SUPPORT OF POINT V, SUBPOINTS C AND D.

The Stock Certificate Is a Contract Complying With the Words of the Statute Allowing the Credit.

In *Geiger* v. *Seeding Machine Co.*, 124 Ohio State 223, it is said at page 237:

> "This court has never been called upon to directly declare that a stock certificate is a contract between the holder and the corporation but several cases have been determined in which that principle has been necessarily assumed. It has many times been declared by courts in other jurisdictions (citing cases). It is not necessary to multiply authority on this point. It is a self evident principle."

In 36 Columbia Law Review, page 1343, where the provision of the law here involved and the regulation is discussed, it is said that the stock certificate satisfies the provisions of the law with reference to a written contract executed by the corporation even if the charter does not. The statement is as follows:

> "But even if it be assumed that there can be no contract with a non-existent entity, an objection which may be met by the theory of novation, the stock certificate which incorporates the terms of the charter, may realistically be viewed as a contract between corporation and shareholder, and therefore within the contemplation of the unqualified statutory term 'contract'."

In the article on the Undistributed Profits Tax in 26 Yale Law Journal at page 26 it is said:

> "It is true that the promotors and not the corporation, 'execute' the charter, but the corporation itself executes the stock certificates. The fact that there is

a written contract executed by the corporation should, moreover be even more clear when the certificates make reference to such restrictive charter provisions. There is no substantial difference between such cases and one where the corporation has executed a separate contract containing the prohibitions."

In the article on the Undistributed Profits Tax in 50 Harvard Law Review 332, it is said at the top of page 341:

"Where the restriction is contained in an amendment to the charter, however, the difficulty that the contract is not executed by the corporation seems absent. Hence the prohibition should be available as the basis of a credit. Furthermore where the restriction is repeated or expressly incorporated by reference in the stock certificate, it may be argued that such charter provision is part of the contract executed by the corporation with its shareholders. Nor should the result differ where there is no express reference to the charter in the certificate but the stock has been purchased in reliance on the restriction."

The Court will take judicial notice that the ordinary purchaser of stock buys it on reliance on the corporation's observance of the provisions of the state law enacted for the shareholders' protection. Substance is controlling in tax cases as this Court, speaking through Mr. Justice Black, said in the quotation at page 30 hereof.

The Provision of the State Law Restricting the Payment of Dividends Is as Fully a Part of the Stock Certificate Contract as if it Were Recopied Therein.

The assertion made in this headline follows from the principle of law often expressed by this and all other Courts and quoted from this Court on page 17 hereof.

In *Thompson* v. *Leggett,* 54 F. (2d) 753 (C. C. A. 9), Judge Wilbur, speaking for the Court, said at page 757:

> "This statutory condition imposed upon the right or privilege of calling in or redeeming preferred stock, although not expressed in the retirement provisions of any of the certificates here involved, is, upon familiar legal principle, to be read into those provisions." (Citing authorities.)

In *Geo. H. Hammond Co.* v. *Hastings,* 134 U. S. 401, this Court said:

> "It was unnecessary to enter upon the certificate any statement of the limitatitons and burdens which the law casts upon all such paper."

In *Jones* v. *Mo. Edison Electric Co.,* 144 Fed. 765, 770 (C. C. A. 8), the Court said:

> "The relationship existing between a corporation and its stockholders is one of contract * * * in which the charter and by-laws of the corporation *and pertinent statutes of the state are embodied.*"

In *Yoakam* v. *Providence Biltmore Hotel Co.,* 34 F. (2d) 533, 541, the Court said:

> "Where possible, we must endeavor to give effect to all provisions of the statute and certificate which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constituent part of the contract entered into.*"

If, as this Court has many times said, substance and not form is controlling in taxation and "taxation is eminently practical" how can it now say that if the provisions of a state law prohibiting dividends are copied in a stock cer-

tificate the taxpayer has relief but otherwise it must pay although its situation in substance is identical in both cases? That to so construe the statute renders it unconstitutional, see page 44 hereof.

Subpoint C.

The Legislative History Supports the Construction of the Law for Which Petitioner Contends Because it Shows the Proponents of the Law Stated Corporations Forbidden By Law to Declare Dividends Were Granted Relief.

As previously pointed out the Board of Tax Appeals decided this case against petitioner entirely on the basis of legislative history. This Board opinion primarily influenced the Court of Appeals for the Second Circuit to reach the same conclusion in *Bastian Bros.* v. *McGowan,* 113 F. (2d) 489. In fairness to the Board it must be pointed out no argument based on legislative history was made to the Board for the taxpayer and it was deprived of the result of a research into such history from the taxpayer's standpoint. Such legislative history argument as it had before it was the *ex parte,* colored, biased argument of respondent (see R. 31-33). As a result of this, important legislative history which we submit would have caused both the Board and the Second Circuit, and we hope will cause this Court, to reach a different conclusion was wholly overlooked.

In the first place the Board uses legislative history addressed to original House and Senate bills differing radically from the one which was enacted into the law now before the Court and which was drafted by the Conference Committee after the House and Senate had originally acted and the Board's attention was not called to vital legislative history of the Conference bill which was the one

that became the law now before this Court. The Board overlooked the history of the bill that became law and used the history of bills that did not become law. In the second place from such legislative history of the original Senate and House bills as it sets out in its opinion the Board made a clearly illogical deduction which is patent on the face of its reasoning.

The Board reasoned that because a bill which originally passed the House contained a provision granting relief to *all* deficit corporations and this was omitted from a bill that originally passed the Senate (the legislative history failing to show the reason for the omission) it conclusively followed from this alone that Congress did not intend by other and more limited provision to grant relief to a limited class of deficit corporations which might otherwise fall within this other and more limited provision and however it may read on its face this other provision must be construed to deny such relief. This does not follow because the debates in the Senate showed that there were only thirty-six states in which corporations with impairment of capital stock were prohibited from declaring dividends (see p. 23, Petition for Certiorari herein). There was no reason why deficit corporations of the remaining twelve states where this prohibition did not exist should be granted relief. The provision in the House bill, granting relief to *all* corporations whether prohibited by charter contract or not from declaring dividends, was too broad because it granted it to corporations of twelve states which did not need it and were in the same situation with respect to the right to declare dividends as surplus corporations. It was probably because of this that the Senate struck it from the bill. Most members of the Senate were lawyers and knew that corporations prohibited by charter contract from declaring dividends were pro-

hibited by contract from doing so. They were in a different situation than corporations which could declare dividends. It was logical for the Senate to consider they were taken care of by the contract provision. They needed relief while the others did not. Indeed the proponents of the bill in the Senate stated they were granted relief as hereinafter appears. There is no provision in the law which could grant them relief except the contract provision. The statement of the proponents of the bill that such corporations were granted relief is the vitally important legislative history overlooked by and not brought to the attention of the Board.

The dissenting Judge who upheld respondent's contention in the case of the *Northwest Steel Rolling Mills case* correctly stated in 110 F. (2d) 290 that the legislative history of the original bill that passed the House and of the original Senate bill "is not helpful." Thereby he rejected the basis of the Board's decision in this case. He called to attention the reason for this stated in Paul & Mertens Supplement to the Law of Income Tax as follows:

> "The House and Senate 1936 Bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of legislative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act."

There is, as above emphasized and here re-emphasized, very pertinent and vital legislative history pertaining to the Conference bill which has heretofore been completely ignored and wholly overlooked. The bill which became law was the one written in conference. The legislative history surrounding this bill shows that its proponents

in the Senate assured those who opposed it that it granted relief to corporations forbidden by law to declare dividends. The Senate Minority Report on the Conference bill, June 19, 1936 (80 Con. Rec. Part 10, page 10164), signed by Senator Walsh and George, states as follows:

> "The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax as well as helped by the lowering of the rates on the normal income tax; that the banks and insurance companies are entirely excluded; and that in some instances corporations under contract not to pay dividends, *and forbidden by law to do so, are permitted without extra penalties* to apply a percentage of their earnings to reserve." (Italics ours.)*

This is quoted from a Conference Report on the very statute which is before the Court and which that Conference Committee drafted and is competent and material. No proponent of the bill denied it was true. From it there can be no question that the proponents of the bill thought corporations forbidden by law to declare dividends were granted relief and gave such assurance to other Senators in order to procure their votes for the bill.

That Congress did not intend to impose the undistributed profits surtax on profits which a corporation was not allowed by law to distribute, even in cases where it had a large surplus, is indicated by the following colloquy (80 Con. Rec., Part 10, page 10265):

> "Mr. Rich: 'What is the difference between an insurance company and a banking corporation and any other corporation so far as trying to save money

*Explaining the original House Bill on behalf of the Ways and Means Committee, Mr. Vinson said (80 C. R. Part 6, page 6212): "It should be stated that in Sections 14 and 15 recognition is taken of State laws, written contracts and the general principles dealing with nontaxation of return of capital."

> for a rainy day is concerned? Why do you exempt banks and insurance companies? If it is good for them why is it not good for any other corporation?'
>
> "Mr. Samuel B. Hill: 'They are compelled by law to keep certain reserves on hand'."

The proponents of the bill stated the same relief was granted other corporations forbidden by law to declare dividends and the same reason and policy dictated that it be granted. Hence the construction we ask harmonizes with the policy of the law.

In view of this it is impossible to say that the legislative history does not support the construction for which petitioner contends. It cannot be used to support a contrary construction without being misunderstood. The subsequent statement of an opponent of the bill (Senator Walsh) denying the construction of the law which he said its proponents placed on it was the correct construction (made in an attempt to defeat the bill) does not serve in the least to detract from the above showing of what the law's proponents (those who drafted it) had in mind.

Point VI.

The Spirit and Purpose of the Undistributed Profits Surtax Law Supports the Construction for Which We Contend.

The purpose, intent and underlying spirit of the law was to prevent rich men avoiding taxes by accumulating large earnings in corporations which they controlled. (See President's Message in House Report No. 2475, 74th Cong. 2nd Sess.) See also examination of witnesses by Senator Black, Senate Hearings, pages 265 to 268. *Sanford* v. *Commissioner*, 106 F. (2d) 882, 884; *Maryland Land & T. Co.*, 40 B. T. A. 1066, 1067.

The President's Message of March 3, 1936, stated as follows:

"The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether."

See also speech of Senator Black, 80 Cong. Rec., pages 8813 and 8814. Senator LaFollette, page 9048.

The Report of the Senate Finance Committee (Report No. 2156, June 1, 1936) stated:

"Your Committee takes the view that the evil sought to be remedied, towit, the retention of profits by corporations to protect investors having large incomes against paying on larger incomes may be soundly corrected without doing the injustices above described."

Certainly the construction for which we contend will allow the law to correct the mischief aimed at and not do injustice.

Stockholders of a corporation, the capital of which was impaired, would not be taxable on distribution made out of capital. *Hadden* v. *Commissioner,* 49 F. (2d) 709 (C. C. A. 2). *Kinnear* v. *Commissioner,* 36 B. T. A. 153. Such stockholders upon return of their capital would always have a loss deductible from other income and which would serve to reduce their taxes otherwise payable on this other income. The purpose of the law was to force taxable divi-

dends into the hands of stockholders to get more tax. A return of capital cannot be and is not made taxable income by statute. It could never increase but would usually decrease a stockholder's taxes.

In the recent case of *United States* v. *American Trucking Associations*, 310 U. S. ....., this Court after observing that when the plain meaning of a statute produced absurd results the Court had refused to follow it, added:

> "Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one plainly at variance with the policy of the legislation as a whole, this court has followed the purpose rather than the literal words."

It is submitted that in the case at bar both the words of the statute and the purpose harmonize with the construction for which we contend.

Also it would have been out of harmony with the spirit and purpose of the law to permit rich and prosperous corporations to avoid this special surtax by electing to distribute income and to take that privilege away from deficit corporations forbidden by law to distribute income and penalize them for being unfortunate and unsuccessful. The President and other proponents of the law stated it was intended to aid small business.

To impose a heavier tax on a corporation with impaired capital stock than on a rich corporation with a surplus would be to ruin the corporation in failing circumstances and promote the prosperous one. We say Congress had no such intent. Yet, under the construction of the Court below, that is what the law does. This construction is at variance with the underlying purpose, spirit and intent of the Act which the opinion of the Court below wholly ignores and is untenable tested from any angle. The Court below failed to read the words of the law against the background of its spirit and purpose.

Point VII.

The Rules of Statutory Construction Applicable Here Make for a Construction in Accord With Petitioner's Contention. Clearly the Court Below Applied the Wrong Rule.

The Court below said of the provision of the law here involved (R. 43):

> "Such provisions in tax laws are to be strictly construed."

Its opinion is an example of the wholehearted application of this thought.

Petitioner replies that even if the provision were strictly construed, nevertheless it is squarely within its words and is entitled to relief; but petitioner submits the Court below failed to apply the proper rule of construction because the provision was referred to in all the Committee reports as a relief provision.

The Senate Committee on Finance said (S. Rep. No. 2156, 74th Cong. 2d Sess., p. 15):

> "Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed profits tax imposed by that bill."

The House Report also referred to it as a relief provision (H. Rep. No. 2475, 74th Cong. 2d Sess., p. 9), saying:

> "A corporation, however, can not use more than one of the relief provisions which is cited but must use the one that will result in the smallest tax."

It has always been the rule in tax cases, applied by this Court, lower Courts and the Tax Board, that a relief provision is to be liberally construed to afford the relief it was intended to provide. *Old Colony Trust Co.* v. *Commis-*

sioner, 301 U. S. 379, 383. *Bonwit Teller & Co.* v. *United States,* 283 U. S. 258, 263. In *Kelly Springfield Tire Co.* v. *United States,* 81 F. (2d) 533, 535 (C. C. A. 3), the Court quotes with approval the following statement of the United States Court of Claims:

> "When a privilege or concession is granted, as in this statute, it is the duty of the court to give the largest and broadest construction in favor of the concession, which the language used will allow in order to afford the relief which the context indicates was intended."

The rule that relief provisions are to be construed liberally has been uniformly applied in tax cases. *Johnson,* 33 B. T. A. 551, 553; *Standifer Construction Co.,* 4 B. T. A. 525, 561.

In the article on the Undistributed Profits Tax in 26 Yale Law Journal at page 25, it is said:

> "It would seem that since the section under consideration was designed to ameliorate a high tax rate, it should be liberally construed in favor of the taxpayer. The Treasury regulations however give it a strict and narrow construction."

See also quotation at page 22 hereof from U. of P. Law Review.

Moreover the relief provision was enacted in a spirit of fairness and was founded on reasons of public policy in order not to offer an inducement to corporations to violate State civil and criminal law prohibiting distribution of dividends except from surplus and in order to keep tottering corporations in business and to prevent discrimination in favor of rich ones. Destruction of small corporations will create monopoly. Even if the law should be considered an exemption it is settled that an exemption granted from motives of public policy is not to be construed strictly but on the contrary is to be construed liber-

ally. *Helvering* v. *Bliss,* 293 U. S. 144, 151; *Cochran* v. *Commissioner,* 78 F. (2d) 176, 179 (C. C. A. 4); *Roches Beach, Inc.* v. *Commissioner,* 96 F. (2d) 776, 779 (C. C. A. 2); *Faulkner* v. *Commissioner,* 112 F. (2d) 987, 991 (C. C. A. 1).

There is another rule of statutory construction applicable here and that is that doubts and ambiguities in a taxing statute are to be resolved in favor of the taxpayer and against the Government. This rule has been many times reiterated by this Court. *Hassett* v. *Welch,* 303 U. S. 303, 314; *Crooks* v. *Harrelson,* 282 U. S. 55, 61. The conflict between the Circuit Courts of Appeal alone (ignoring the above quotations from the law reviews of our leading universities) indicates that the law is doubtful. If so, the doubt must be resolved in the taxpayer's favor. The oft applied rule that Statutes in favor of those on whom taxes are assessed are remedial and are to be so liberally construed that the letter of them may be extended to embrace cases within the mischief intended to be prevented, is stated in Lewis & Sutherland on Statutory Construction, Vol. 2, Sec. 680, p. 1075.

The above rules the learned Court below wholly ignored and used opposite rules to reach its decision.

Point VIII.

If Construed as Urged By Respondent the Statute Violates the Fifth Amendment.

If the taxpayer had recopied the provisions of the State law into its stock certificate it would be unquestionably granted relief. (See authorities cited on page 29 hereof.) However, it is in exactly the same situation with respect to the payment of dividends. Although it has not recopied the State law into its stock certificate that provision is recopied into the certificate by virtue of the rule stated by this Court and quoted on page 17 hereof

and applied by the Court of Appeals for the Ninth Circuit in *Northwest Steel Rolling Mills case.* See also *Geo. H. Hammond Co.* v. *Hastings,* 134 U. S. 401. If the statute be construed to grant relief in one of these cases and deny it in another then it makes an unreasonable, defenseless classification and fails to meet the definition of reasonable classification set forth by this Court in *Traux* v. *Corrigan,* 257 U. S. 312, at page 337. It is so arbitrary and capricious that it violates the Fifth Amendment. *Nichols* v. *Coolidge,* 274 U. S. 531; *Untermeyer* v. *Anderson,* 276 U. S. 440; *Heiner* v. *Donnan,* 285 U. S. 312; *Helvering* v. *City Bank,* 296 U. S. 85, 92; *Hoeper* v. *Tax Commission,* 284 U. S. 206.

Another constitutional objection is that an income tax on corporations is an excise (*Flint* v. *Stone Tracy Co.,* 220 U. S. 107), which the constitution requires to be uniform. This statute imposes a higher rate on undistributed than on other income. The tax does not operate with geographical uniformity throughout the United States because it gives deficit corporations incorporated under the laws of twelve states an election to avoid it and no election to those formed in other thirty-six states. This is an indefensible discrimination. The construction for which we contend says Congress did not intend to make it while that for which respondent contends holds it did. This Court has said a national law should be construed if possible to operate uniformly.

Also the failure to tax corporations which recopied the state law in the stock certificate and those which did not although both are in an identical situation, violates the uniformity guaranty. In *Miller* v. *Nut Margarine Co.,* 284 U. S. 489 at page 510, this Court said of failure to tax others identically situated:

> "Such discrimination conflicts with the principle underlying the constitutional provision directing that

excises laid by Congress shall be uniform throughout the United States."

Berman v. *Board of Education of City of Chicago,* 360 Ill. 535 at pages 542, 543 is a reiteration of the holding that under the constitutional due process clause "a law must be binding upon and affect alike each member of the community of the same class." *Cf. Hartford Insurance Co.* v. *Harrison,* 301 U. S. 459.

Also if the construction urged by the respondent should be adopted it would permit wealthy corporations to avoid the surtax by distributing a dividend and grant no election to avoid it to a poor and tottering corporation. It would open a relief door to the rich and none to the poor. One does not need it and the other does. It would penalize the poor one at the expense of the rich and this without any reasonable basis. It would tend to drive the poor ones out of business and concentrate business in the rich ones and create monopoly which is against the public policy of this country as evidenced by the Statutes against monopoly. Also it would be contrary to the declared purpose of the law's proponents, including the President, to aid small business.

Also if construed as respondent contends it should be, the statute makes a baseless distinction between charter contracts and all other contracts. As the Court of Appeals for the Ninth Circuit held in the *Northwest Steel Rolling Mills case* (110 F. (2d) at page 290) this one arbitrary distinction alone casts grave doubt on its constitutionality.*

*In its recent decision in Prudential Tobacco Co., 42 B. T. A. No. 80 upholding the constitutionality of this law the Board of Tax Appeals said: "While we are not entirely free from doubt upon the present question, nevertheless, we are unwilling to declare it unconstitutional upon the present record." In that case however, the above arguments were not made and it was only argued that the law was unconstitutional because it was retroactive until January 1, 1936; that where a corporation's fiscal year ended March 31, 1936 it had no notice of the law and no opportunity to declare dividends during the taxable year and avoid the tax. The 1936 act became law June 2, 1936.

It must be borne in mind that the undistributed profits tax is not an income tax laid on all income like all preceding income taxes the country has known but is a tax laid only on undistributed income. It may be avoided by distributing income. Its design was to force distribution of income in order to collect more taxes from stockholders and it is in substance a penalty for failure to distribute income. To say that Congress has power to impose an income tax on the income of a corporation even if it has a deficit is entirely different from saying that Congress has power to impose a tax according to the use to which income is put and condition an income tax upon a corporation's failure to unlawfully distribute its earnings in dividends. **Can Congress condition an income tax on the failure to do an unlawful act?** The income tax is a uniform income tax or excise levied for the support of the Government while this tax is designed to regulate the internal affairs of the corporation (see 46 Yale Journal at p. 48) by forcing it to pay out its earnings. The regulation of a corporation's internal affairs is a matter reserved by the Tenth Amendment to the States. *United States* v. *Butler,* 297 U. S. 1. It is for the State to declare its own public policy with respect to the declaration of dividends by corporations which it creates. *Hopkins Fed. S. & L. Asso.* v. *Cleary,* 296 U. S. 315, at page 337. See also 2 John Marshall Law Quarterly 340. Also the tax puts a higher rate on undistributed income dollar than put on the distributed income dollar.

The tax upheld in *Helvering* v. *National Grocery Co.,* 304 U. S. 282, was a tax on the failure to do a lawful act, whereas the tax in the case at bar is not imposed unless the corporation has failed to do an unlawful act—if the construction of the law upheld by the Court below be the correct one.

The construction urged by respondent says in effect: "If you do a criminal act you shall not be taxed, but if you fail to you shall be taxed." Would anyone doubt the unconstitutionality of a tax statute which provided for taxing trucks in interstate commerce at 1c per mile with a "credit" for all miles the driver drove on the left-hand side of the road at 70 miles per hour or more? But this is the effect of what respondent contends when he says corporations must pay unless their directors violate the civil and criminal laws of the states.*

It would also put a premium on the violation of the criminal law of most of the states and the civil law of 36 of them and hold out an inducement to violate not only state criminal law but state civil law. No federal statute should be so construed unless there is no escape from such a construction.

The Court is asked to read the article on the constitutionality of the law in XIV Tax Magazine 640.

As the Circuit Court of Appeals for the Ninth Circuit held, it is not necessary to so construe it. It is unnecessary to read the statute to say an income tax is by it conditioned on the failure to do an unlawful act. As said by Mr. Justice Holmes in *United States* v. *Jin Fuey Moy,* 241 U. S. 394, 401:

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score. *United States ex rel. Atty Gen.* v. *Delaware & H. Co.,* 213 U. S. 366, 408, 63 L. Ed. 836, 849, 29 Sup. Ct. Rep. 527."

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*In most states it is a crime to declare a dividend out of capital. Thus see Section 664 of the New York Penal Law making it a misdemeanor to vote for a dividend except from surplus. That it is also a misdemeanor at common law in a case where the Civil Statutes impose a duty on directors not to declare a dividend except from surplus and the Criminal Law is silent see 14 Corpus Juris, Sec. 2073, page 244.

Finally, and wholly apart from the constitutional question, the construction asked by respondent produces such unfair results that it ought not to be made by this Court. Certainly it is not necessary to make it. "Taxation is an intensely practical matter, and laws in respect of it should be construed and applied with a view to avoiding so far as possible unjust and oppressive consequences." *Farmers L. & T. Co.* v. *Minnesota,* 280 U. S. 204, 212

CONCLUSION.

In conclusion it is respectfully submitted that the judgment below should be reversed.

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APPENDIX.

Statutes Involved.

(U. S. C. Supp. III, Title 26, Sec. 13a.)

Sec. 26. **Credits of Corporations.**

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

North Dakota Compiled Laws—Supplement—(Annotated), 1913-1925:

> "SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, * * *"

Treasury Regulations 94 (1936 Ed.), promulgated under the Revenue Act of 1936:

> "The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c)."